INDEX

	Page
Opinion below	1
Jurisdiction	1
The question presented	2
The statutes	2
Statement	3
Summary of argument	8
Argument:	
I. Nothing short of a settlement made in the form prescribed by law and with the approval of officers designated by law should be accepted as mutually binding on taxpayers and the United States	9
II. The findings of the Court of Claims are not sufficiently complete to justify this Court in ordering judgment for a definite sum, and the case should be remanded to the Court of Claims for additional findings if the settlement is held not conclusive	14
Conclusion	17

CITATIONS

Cases:	
Gray, William S., & Co. v. *United States;* pending in Court of Claims	16
Leach v. *Nichols*, 23 F. (2d), 275	13
United States v. *Philadelphia Knitting Mills Co.*, 273 Fed. 657	15, 16
Statutes:	
Revenue Act of 1916, c. 463, sec. 12(a), 39 Stat. 756, 767	3, 14
Revenue Act of 1918, c. 18, sec. 234(a)(1), 40 Stat. 1057, 1077	15
Revenue Act of 1921, c. 136, 42 Stat. 227, 313—	
Sec. 1312	10
Sec. 1313	11
Revenue Act of 1924, c. 234, sec. 1006, 43 Stat. 253, 340; U. S. C. title 26, sec. 1249	11
Revenue Act of 1926, c. 27, sec. 1106(b), 44 Stat. 9, 113; U. S. C. App. title 26, sec. 1249	11
Revised Statutes, sec. 3229; U. S. C. title 26, sec. 158	2, 10

In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 659

BOTANY WORSTED MILLS, PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 21) is reported in 63 C. Cls. 405.

JURISDICTION

The judgment sought to be reviewed was entered April 4, 1927. (R. 26.) The petitioner seasonably filed a motion for new trial, which was entertained and overruled November 7, 1927. (R. 27.) The petition for certiorari was filed December 22, 1927 (R. 27) and granted without opposition from the United States. The jurisdiction of this Court rests on the Act of February 13, 1925.

THE QUESTION PRESENTED

The question presented is whether an adjustment, made in 1920, of a taxpayer's income tax liability for the year 1917, resulting from mutual concessions by the taxpayer and the representatives of the Bureau of Internal Revenue, put into effect by the making of an amended return and the payment of the tax assessed upon it, operates as an executed contract of settlement binding the taxpayer and precluding him from maintaining a suit for taxes erroneously or illegally assessed and collected, where there has been no compromise or conclusive agreement made in accordance with the provisions of the statute authorizing them.

If the question above stated is answered in the negative, the remaining question is whether the findings of the Court of Claims are sufficient and complete enough to justify this Court in directing the entry of a judgment for the petitioner for a stated sum, or whether the case should be remanded to the Court of Claims for further evidence or findings as to the nature of the payments made to the petitioner's directors and as to whether they were ordinary and necessary expenses of the corporation, deductible in computing taxable income.

THE STATUTES

Section 3229, Revised Statutes (U. S. C. Title 26, Sec. 158), is as follows:

> The Commissioner of Internal Revenue, with the advice and consent of the Secretary

> of the Treasury, may compromise any civil or criminal case arising under the internal-revenue laws instead of commencing suit thereon; and, with the advice and consent of the said Secretary and the recommendation of the Attorney General, he may compromise any such case after a suit thereon has been commenced. Whenever a compromise is made in any case there shall be placed on file in the office of the Commissioner the opinion of the Solicitor of Internal Revenue, or of the officer acting as such, with his reasons therefor, with a statement of the amount of tax assessed, the amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and the amount actually paid in accordance with the terms of the compromise.

Section 12 (a) of the Revenue Act of 1916 (c. 463, 39 Stat. 756, 767) provides for the deduction, in the case of a corporation, from gross income in order to determine taxable net income, of—

> All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.

STATEMENT

In this action the petitioner sought to recover $450,994.06, with interest, assessed against it and

paid as additional income and excess-profits taxes for the year 1917, and was denied recovery in the Court of Claims on the ground that there had been a contract of settlement resulting from mutual concessions made by the taxpayer and the representatives of the Bureau of Internal Revenue, resulting in an adjustment in 1919 of the amount of the taxable income for 1917, and which was followed in 1920 by an amended return based on the adjustment arrived at, and the assessment and payment of the tax computed thereon.

The findings show that the petitioner is a corporation organized under the laws of New Jersey and engaged in the business of manufacturing woolen and worsted fabrics and selling them in the United States and elsewhere. (R. 10.) The corporation made an income-tax return for 1917. Thereafter, its books were audited by the Bureau of Internal Revenue with a view to readjustment of the income and excess-profits taxes of the corporation for the years 1916, 1917, and part of 1918. It appears that as a result of this audit three questions arose in respect of matters entering into the computation of the taxable income. The first was the propriety of allowing as an ordinary and necessary expense amounts paid to the company's directors purporting to be compensation for services; the second was the amount of depreciation on buildings and machinery to be charged off, and the third was the propriety of certain deductions for reserves charged

to expenses. The findings do not disclose any facts relating to the merits of the differences arising on account of depreciation and reserves, and leave us in the dark as to whether the Bureau of Internal Revenue or the taxpayer was right with respect to those items. As to the amount paid to the company's directors for compensation, the findings disclose that it has been the practice of many corporations engaged in the woolen-manufacturing business to provide compensation for the services of directors and executive officers on the basis of a percentage of profits (R. 20); that ever since its organization, in January, 1890, the petitioner's by-laws have provided a plan for annual division of the profits by which, after first providing for 6% on the stock and the creation of reserve, a percentage of the profits has been paid as a bonus or as compensation to the directors for their services. (R. 12–14.) Some changes in these by-laws were made from time to time, but the plan in effect has not varied greatly, and during the year 1917 a by-law (last amended on March 17, 1908) was in effect which read as follows (R. 14):

> PAR. 1. After the close of the first half of every business year of the company a computation of profits shall be made, and if practicable a dividend not exceeding three (3) per centum shall be paid to the stockholders. This dividend shall be payable on September 15th following.

PAR. 2. At the close of the business year the net profits shall be distributed as follows, after suitable deductions shall have been made from the value of the property of the company:

(1) A dividend of six (6) per centum is to be paid to the stockholders, in the computation of which said dividend payable on September 15th of the same business year shall be included.

(2) The balance remaining is to be applied as follows:

(a) Five (5%) per centum thereof shall be placed in a reserve fund until the amount of the reserve fund accumulated shall be equal to twenty (20%) per centum of the paid-up capital of the company for the time being.

(b) A compensation equal to thirty-two (32%) per centum of the said balance shall be allowed or paid to the board of directors for their services.

(c) The residue is to be applied to the payment of an additional dividend to the stockholders, which is to be determined by the board of directors, subject to the approval of the stockholders at the annual meeting assembled. The board of directors may, however, with such approval of the stockholders, use a portion of said residue referred to in this paragraph (c) for special deductions from accounts or for the formation of special reserve funds or additional reserves, or for extra compensation to be paid

> to employees, or for any institutions which are designed to benefit the employees, such as pension funds and other similar institutions.
>
> Said additional dividend shall be payable on April 15th following the declaration thereof, unless the directors, with the approval of the stockholders, appoint another day for its payment.

The net income of the petitioner for 1917 was $7,953,512.80 (R. 17), and under the foregoing by-law it distributed $1,565,739.39 to the 10 directors in addition to their fixed salaries of $9,000 per annum (R. 11). In filing its return for 1917 the petitioner sought to take as a deduction the full amount of the payment to the directors, but was notified by the Bureau of Internal Revenue that this deduction would not be allowed. (R. 11.)

The findings then state that (R. 18):

> After much correspondence and numerous conferences extending over a period of several months in which the plaintiff was represented by its attorney * * * the defendant represented by Sidney Alexander, chief of the special audit section, Bureau of Internal Revenue, and others of his official associates, a compromise was agreed to as to all of the differences.

These conferences appear to have commenced in 1919 and continued into 1920. (R. 11, 19.)

The items of depreciation and reserves claimed by the petitioner were allowed, but of the aggregate

sum of $1,565,739.39 paid to the directors as compensation the Commissioner of Internal Revenue disallowed $783,656.06. (R. 11.) In accordance with this adjustment, petitioner, in 1920, filed amended returns based on the figures agreed upon in the conferences, and the tax so computed was paid by the petitioner. (R. 20.) Of the additional assessment then made and paid, $450,994.06 was attributable to the disallowance by the Bureau of Internal Revenue as a deduction of part of the amount paid directors as compensation (R. 11), and it is to recover that amount that this suit was brought.

SUMMARY OF ARGUMENT

I. Acts of Congress relating to internal revenue taxes disclose a legislative intention that no adjustment of a tax controversy between the Bureau of Internal Revenue and the taxpayer is binding or conclusive unless made with the formalities prescribed by law and with the approval of officers designated by statute. These statutes are inconsistent with the contention that informal concessions and adjustments between taxpayers and representatives of the Bureau are binding on the taxpayer and the United States. While the rule that such an informal adjustment is binding would save this case for the United States, it is not in the interests of the United States or in accordance with sound public policy that such a rule be adopted. In deference to the opinion of the Court of Claims

and the importance of the question, we submit it for decision.

II. Although the question of settlement may be resolved in favor of the petitioner, the findings bearing on the question whether the amounts paid directors were compensation and necessary expenses, deductible from gross income in computing net taxable income, are not complete enough to justify this Court in directing the entry of a judgment for a stated sum, and the case should be remanded to the Court of Claims for additional findings, with leave to that court to hear additional evidence for either party.

ARGUMENT

I

NOTHING SHORT OF A SETTLEMENT MADE IN THE FORM PRESCRIBED BY LAW AND WITH THE APPROVAL OF OFFICERS DESIGNATED BY LAW SHOULD BE ACCEPTED AS MUTUALLY BINDING ON TAXPAYERS AND THE UNITED STATES

The primary question in this case is whether the Court of Claims was right in denying relief to the petitioner on the ground that a contract of settlement had been made which was binding on the parties. The court below held that but for this settlement the petitioner was entitled to recover.

The question whether adjustments brought about by mutual concessions in conference between taxpayers and representatives of the Bureau of In-

ternal Revenue, and put into effect by the filing of amended returns and the payment of the readjusted taxes, operate as contracts of settlement binding upon the parties, is one of importance. In this case to treat the arrangement as a binding settlement would operate to the advantage of the United States, but the application of the rule announced by the Court of Claims in this case would prevent the Treasury Department from reconsidering any cases in which adjustments have been so arrived at.

Section 3229, R. S., above quoted, which was in force at the time of the transactions here involved, and is still in effect, lays down a method by which the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, and in some cases with the additional recommendation of the Attorney General, may make compromises and settlements of cases arising under the internal revenue laws. That statute was not complied with in this case.

Since the date of the alleged settlement here involved, and by the Revenue Act of 1921 (c. 136, 42 Stat. 227, 313), Sections 1312 and 1313, it was provided:

> SEC. 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in

writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

SEC. 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

Like methods of making conclusive agreements were prescribed by Section 1006 of the Revenue Act of 1924 (c. 234, 43 Stat. 253, 340; U. S. C. Title 26, Sec. 1249) and Section 1106(b) of the Revenue Act of 1926 (c. 27, 44 Stat. 9, 113; U. S. C. App., Title 26, Sec. 1249).

Before and since the date of the alleged settlement in this case Congress has evidently proceeded

on the theory that no adjustment of a tax controversy between representatives of the Bureau of Internal Revenue and a taxpayer is binding unless made with the formalities and with the approval of the officials prescribed by statute.

The authority of officers of the United States to compromise claims on behalf of or against the United States is strictly limited. It does not seem to be in accord with sound public policy that informal concessions and adjustments such as this record discloses be held binding on the taxpayer, and therefore upon the United States. The statutes which authorize conclusive agreements and settlements to be made in particular ways and with the approval of designated officers raise the inference that adjustments or settlements made in other ways are not binding.

No ground for the United States to claim estoppel is disclosed in the findings. They show that for petitioner's concession about compensation of directors the representatives of the Bureau of Internal Revenue acquiesced in the petitioner's claims respecting depreciation and reserves for the same tax year, but there is nothing in the findings to show that the representatives of the Bureau yielded in the matter of depreciation and reserves anything which the taxpayer was not entitled to, or that the United States has lost any rights as the result of such concessions. If the adjustment of the 1917 tax is not conclusive, the United States,

on a judicial inquiry as to the correct amount of the tax for 1917, is in as good a position as it ever was to question all deductions, to the extent necessary to defeat this claim.

In the case of *Leach* v. *Nichols,* 23 F. (2d), 275, decided December 27, 1927, by the Circuit Court of Appeals for the First Circuit, it was held that compromises of tax matters are not binding unless made in the manner prescribed by statute. The alleged settlement agreement in that case was made November 23, 1921, the very day of the approval of the Revenue Act of 1921, containing Sections 1312 and 1313, above quoted, and the court dealt with the case as if Section 3229 of the Revised Statutes, above quoted, was, as in the present case it was, the only statute in force relating to compromises of tax disputes.

It is but fair to the Court of Claims to say that at the trial of this case attorneys for the Bureau of Internal Revenue, with commendable zeal for obtaining success in this case, took the position that there was a binding agreement of settlement. On the petitioner's motion for new trial, the attorneys for the Bureau of Internal Revenue conceded that there was no binding agreement of settlement, but made a claim that the taxpayer was estopped to question the adjustment. The findings do not disclose a ground for estoppel. In other cases now pending in other courts the attorneys for the Bureau of Internal Revenue are taking the position

that no settlement or compromise is binding on a taxpayer or on the United States unless made in the manner prescribed by statute.

There are other cases pending in the Court of Claims involving the same problem.

Because of the importance of the question and in deference to the opinion of the Court of Claims, the question is submitted for the judgment of this Court.

II

THE FINDINGS OF THE COURT OF CLAIMS ARE NOT SUFFICIENTLY COMPLETE TO JUSTIFY THIS COURT IN ORDERING JUDGMENT FOR A DEFINITE SUM, AND THE CASE SHOULD BE REMANDED TO THE COURT OF CLAIMS FOR ADDITIONAL FINDINGS IF THE SETTLEMENT IS HELD NOT CONCLUSIVE

If this Court reaches the conclusion that the alleged settlement was not binding on the petitioner, the remaining question is whether, on the findings of fact made by the Court of Claims, the petitioner is entitled to a judgment for a definite sum. Stated otherwise, the question is whether the findings show that the amounts paid directors for 1917 were in fact compensation and were "ordinary or necessary expenses." The 1916 Act, above quoted, allows the deduction of—

> All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties.

The 1918 Act, which followed it (c. 18, 40 Stat. 1057, 1077), in Section 234(a) (1), provided for deduction of—

> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. * * *

In *United States* v. *Philadelphia Knitting Mills Co.*, 273 Fed. 657, decided in 1921, arising under the Corporation Excise Tax Act of 1909, which allowed the deduction of "ordinary and necessary expenses," it was stated that it was not open to the Bureau of Internal Revenue to inquire into the reasonableness of the compensation paid to officers and employees, but the court said (page 658):

> But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the Government may inquire whether the amount paid is salary or something else. * * * It has a right, therefore, to attack the action of a board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances, the whole or some part of it is not salary at all but is profits diverted to a stockholding officer under the guise of salary and as such is subject to taxation.

As the decision was for the United States, it had no occasion to attempt to have it reviewed here because of anything said in the opinion.

In the case of *William S. Gray & Co.* v. *United States,* decided by the Court of Claims June 6, 1927, the court approved the statement in *United States* v. *Philadelphia Knitting Mills Co., supra,* but it has since granted a motion for new trial made by the United States, and the case is still pending in the Court of Claims.

In the present case the Court of Claims held that the settlement was conclusive. True, it has made findings on the question whether the amounts paid directors were compensation and whether they were ordinary and necessary expenses and expressed the opinion that they were; but because of its conclusion that the settlement point disposed of the case, its findings bearing on the other question are not as complete as they might have been. The findings show that the practice of paying the directors a percentage of the profits had been followed by this corporation for many years. They also show that the directors to whom these payments were made held positions as executive officers or managers of certain departments of the business. (R. 16.) There are no findings as to the extent of the service rendered by each or whether the distribution was made in proportion to the

value of the services of each, nor is there any finding as to the reasonable value of the services rendered or whether the payments were far in excess of any that might be justified as compensation for service performed. There are no findings as to the other relations which the directors bore to the corporation or as to the amount of stock held by each. We do not contend that the findings affirmatively show that the amounts paid to directors were not properly deductible. On the other hand, we can not concede that the findings are complete and adequate to support the contention that the $1,565,739.39 paid to the ten directors was for services rendered and an "ordinary and necessary expense."

The Court of Claims states that the United States did not contend that the sums paid were not in fact compensation, but only that the amount was unreasonable. The Bureau insists that the Court of Claims misunderstood its position, and that the claim that the amounts paid were unreasonable was made to sustain the claim that the sums were too large to be considered compensation, or an ordinary or necessary expense.

CONCLUSION

If the alleged settlement is held not conclusive and the judgment below is reversed, the case should be remanded to the Court of Claims for additional

findings bearing on the other issues, with leave to the Court of Claims to hear additional evidence.

Respectfully submitted.

WILLIAM D. MITCHELL,
Solicitor General.

APRIL, 1928.

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